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**REPORT FROM THE COMMISSION**

**Finland**

**Report prepared in accordance with Article 126(3) of the Treaty**

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# 1. LEGAL BACKGROUND

Article 126 of the Treaty on the Functioning of the European Union (TFEU) lays down the excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact. Specific provisions for euro area Member States under EDP are laid down in Regulation (EU) No 473/2013[2].

According to Article 126(2) TFEU, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 126(3) TFEU stipulates that, if a Member State does not fulfil the requirements under one or both of the above criteria, the Commission has to prepare a report. The Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criteria, it is of the opinion that there is a risk of an excessive deficit, the latter understood as the situation defined in Article 126(2) TFEU. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

This report, which represents the first step in the EDP, analyses whether or not Finland is compliant with the debt criterion of the Treaty, with due regard to the economic background and other relevant factors.

Following the amendments to the Stability and Growth Pact in 2011, the debt requirement has been put on an equal footing with the deficit requirement in order to ensure that, for countries with a debt-to-GDP ratio above the 60% reference value, the ratio is brought below (or sufficiently declining towards) that value.

According to the Draft Budgetary Plan, communicated to the Commission on 15 October 2013, the general government deficit for 2014 is expected to reach 1.9% of GDP while the gross debt ratio would reach 60.7% by the end of 2014, above the 60% of GDP reference

[1] OJ L 209, 2.8.1997, p. 6. The report also takes into account the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 3 September 2012, available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm .

[2] OJ L 140, 27.5.2013, p. 11: Regulation (EU) No 473/2013 of the European Parliament and of the Council on "common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area".

value. According to the Commission 2013 Autumn Forecast, the debt ratio would reach 61.0% of GDP.

The planned figure, both in the Commission forecast and in draft budgetary plan for the 2014 debt provides *prima facie* evidence on the risk of the existence of an excessive deficit based on the debt criterion in Finland in the sense of the the Stability and Growth Pact. The Commission has therefore prepared the following report in order to comprehensively assess the excess over the reference value, in order to conclude whether the breach of the debt criterion merits the launch of an EDP. Section 2 examines the debt criterion and relevant factors influencing the developments in debt level. The report takes into account the Commission 2013 Autumn Forecast, released on 5 November 2013.

## 2. DEBT CRITERION

The general government gross debt ratio has increased rapidly over the last years, growing from 48.7% of GDP in 2010 to estimated 58.3% in 2013. According to the Commission 2013 Autumn Forecast, the debt would reach 61.0% in 2014. Finland's Draft Budgetary Plan forecasts the increase to 60.7% in 2014. The difference is due to the fact that for 2014 the Commission forecasts a lower primary balance and a smaller positive effect from GDP growth. It is forecast that the debt ratio would increase also in 2015, reaching 62.5% according to the Commission forecast and 62.0% according to the national forecast.

**Table 1: Debt dynamics**

| | **2010** | **2011** | **2012** | **2013** | **2014** | **2015** |
|---|---|---|---|---|---|---|
| Government gross debt ratio | 48.7 | 49.2 | 53.6 | 58.4 | 61.0 | 62.5 |
| Change in debt ratio [b] (1 = 2+3+4) | 5.1 | 0.6 | 4.3 | 4.8 | 2.6 | 1.5 |
| *Contributions:* | | | | | | |
| • Primary balance (2) | 1.4 | -0.4 | 0.7 | 1.2 | 1.3 | 1.1 |
| • “Snowball” effect (3) | -0.5 | -1.4 | 0.0 | 0.2 | -0.5 | -1.1 |
| *of which:* | | | | | | |
| *Interest expenditure* | *1.1* | *1.1* | *1.0* | *1.0* | *1.0* | *1.0* |
| *Real GDP growth* | *-1.4* | *-1.3* | *0.4* | *0.3* | *-0.3* | *-0.9* |
| *Inflation (GDP deflator)* | *-0.1* | *-1.3* | *-1.4* | *-1.2* | *-1.2* | *-1.2* |
| • Stock-flow adjustment (4) | 4.2 | 2.4 | 3.6 | 3.5 | 1.9 | 1.6 |

Notes:

[a] In percent of GDP.

[b] The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left( \frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where $t$ is a time subscript; $D$, $PD$, $Y$ and $SF$ are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and $i$ and $y$ represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect, measuring the combined effect of interest expenditure and economic growth on the debt ratio.

*Source: Eurostat and Commission 2013 autumn forecasts.*

## 3. RELEVANT FACTORS

Article 126(3) of the TFEU provides that the Commission report "shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors, including the medium-term economic and budgetary position of the Member State in order to decide whether the breach of the criterion merits the launch of an EDP for the Member State in question. These factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97, which also specifies that "any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council" need to be given due consideration.

In view of the above provisions, the following subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position (including public investment); (3) the developments in the medium-term government debt position, its dynamics and sustainability; (4) other factors put forward by the Member State; and (5) other factors considered relevant by the Commission.

### 3.1. Medium-term economic position

**Cyclical conditions and potential growth.** After Finland's GDP decreased by 8.5% in 2009, the country recovered at satisfactory pace over 2010 and 2011, but has experienced a new recession over 2012 and 2013. The crises has negatively affected Finland's potential growth. Before the crises, in 2007, potential growth was estimated at 2.3% but has decreased to 0.4% in 2012. Capital accumulation remains the only positively contributing element for potential output growth. Potential growth is forecast to improve only slightly, to 0.6% in 2015.

Real GDP declined in 2012 and is forecast to decline also in 2013, opening up a large output gap. Growth is forecast to exceed potential growth over 2014-15. This will not be sufficient to close the output gap but it is expected to narrow from -2.7% of potential GDP in 2013 to -1.6% in 2015.

**Table 2: Macroeconomic and budgetary developments** [a]

| | 2010 | 2011 | 2012 | 2013 | | 2014 | |
|---|---|---|---|---|---|---|---|
| | COM | COM | COM | COM | National authorities | COM | National authorities |
| Real GDP (% change) | 3.4 | 2.7 | -0.8 | -0.6 | -0.5 | 0.6 | 1.2 |
| Potential GDP (% change) | 0.4 | 0.5 | 0.4 | 0.3 | | 0.3 | |
| Output gap (% of potential GDP) | -2.8 | -0.6 | -1.8 | -2.7 | -3.3 | -2.5 | -2.9 |
| General government balance | -2.5 | -0.7 | -1.8 | -2.2 | -2.2 | -2.3 | -2.2 |
| Primary balance | -1.4 | 0.4 | -0.7 | -1.2 | -1.2 | -1.3 | -1.2 |
| One-off and other temporary measures | -0.1 | -0.1 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| Government gross fixed capital formation | 2.5 | 2.5 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 |
| Cyclically-adjusted balance | -1.0 | -0.4 | -0.8 | -0.8 | -0.5 | -1.0 | -0.5 |
| Cyclically-adjusted primary balance | 0.0 | 0.7 | 0.2 | 0.2 | 0.5 | 0.1 | 0.5 |
| Structural balance [b] | -0.9 | -0.3 | -0.7 | -0.8 | -0.5 | -1.0 | -0.5 |
| Structural primary balance | 0.1 | 0.8 | 0.3 | 0.2 | 0.5 | 0.1 | 0.5 |

Notes:

[a] In percent of GDP unless specified otherwise.

[b] Cyclically-adjusted balance excluding one-off and other temporary measures.

*Source: Eurostat and Commission 2013 autumn forecasts.*

Article 2(1a) of Regulation (EC) No 1467/97 stipulates that the requirement under the debt criterion shall also take in account the influence of the cycle on the pace of debt reduction.

In this respect, it seems that the negative cyclical developments over the recent years have had a significant impact on the debt ratio. Indeed, once corrected for the cycle over the last three years, the debt ratio in 2014 would remain below the Treaty reference value.

**Table 3. General government deficit and debt (% of GDP)[3]**

| | | 2010 | 2011 | 2012 | 2013 | | 2014 | | 2015 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | COM | National authorities | COM | National authorities | COM | National authorities |
| Deficit criterion | General government balance | -2.5 | -0.7 | -1.8 | -2.2 | -2.2 | -2.3 | -1.9 | -2.0 | X |
| Debt criterion | General government gross debt | 48.7 | 49.2 | 53.6 | 58.4 | 58.3 | 61.0 | 60.7 | 62.5 | X |
| | General government gross debt adjusted for the effect of the cycle | | | | | | 56.3 | | | |

**Recent structural reforms.** Assessment of the reform actions undertaken by the Finnish authorities in response to the recommendations issued by the Council in July 2012 in the context of the EU semester was generally positive. It was considered that Finland had implemented the planned fiscal consolidation measures. Comprehensive reforms of the municipal structure, healthcare and social services have been prepared, the youth guarantee has been extended, early exit pathways from the labour market have been reduced, the national competition authority has been reformed and tax incentives have been temporarily offered to support R&D and investments.

Finland is reforming the corporate income tax system from 2014, reducing the corporate income tax rate and increasing the dividend taxation. The aim is to increase growth-friendliness of the tax system.

Since the Council gave new recommendations to Finland in July 2013, the government has adopted a broad structural reform programme for improving the growth conditions and reducing the sustainability gap. The government is foreseeing measures to balance local government finances, to increase the efficiency of the public sector, to extend working careers by 2 years and to improve competition and competitiveness.

Depending on the implementation details still to be decided, these measures could have a significant positive impact on public finances in the medium term through increased growth and expenditure reduction.

3 The cyclically-adjusted debt is computed as:

$$\left(\frac{B_t}{Y_t}\right)^{3-years\ -adjusted} = \left(\frac{B_t + \sum_{j=0}^{2}\left(C_{t-j}\right)}{Y_{t-3}\prod_{h=0}^{2}(1+y_{t-h}^{pot})(1+p_{t-h})}\right)$$

where Bt stands for debt, Yt for GDP at current price, ypot for potential growth, pt for the price deflator of GDP, Ct for the cyclical part of the budget balance. The cyclical components and potential growth are calculated according to commonly agreed methodologies.

### 3.2. Medium-term budgetary position

**Structural deficit and fiscal consolidation.** During the recovery of 2009-10, Finland improved the structural balance significantly, reaching -0.3% of GDP by end 2011. With the economic decline over 2012-13, also the structural balance started to deteriorate, falling to -0.7% in 2012. In all years, Finland's headline deficit has been below 3% of GDP and is forecast to remain so over the forecast horizon. Finland had a MTO of +0.5% until 2013, when it was adjusted to -0.5%. Finland has thus not reached the MTO in 2012, although it plans to do so in 2013 according to the Draft Budgetary Plan.

With growth expected to return in 2014, Finland's Draft Budgetary Plan aims to marginally improve the structural balance. However, according to the Commission 2013 Autumn Forecasts the structural balance deteriorates further with a risk of significant deviation from the MTO.

Article 2(1a) of Regulation (EC) No 1467/97 stipulates that the requirement under the debt criterion shall also be considered to be fulfilled if the budgetary forecasts of the Commission indicate that the required reduction in the differential with respect to the reference value will occur over the three-year period encompassing the two years following the final year for which data is available.

The Commission forecast as well as the plans and forecasts of the authorities show that debt has been on an upward trend and is expected to remain so over the forecast horizon. Assuming no change in policies and based on both current forecasts by the Commission and by the authorities, the forward-looking debt benchmark shows that the debt ratio will not be diminishing sufficiently.

### 3.3. Medium-term government debt position

**Long-term sustainability of public finances.** Finland appears not to be at risk of fiscal stress in the short term but is at medium sustainability risk in the medium term and at high risk in the long term due to the budgetary impact of the cost of ageing. The focus, therefore, should be on containing age-related expenditure growth further so as to contribute to the sustainability of public finances in the medium and long term.

According to the 2012 Ageing Report reference scenario, Finland’s public healthcare expenditure is set to increase significantly from 6.0% of GDP to 7.0% of GDP by 2060. Among the many measures being proposed is the consolidation of reform efforts already being made by, for example, increasing hospital efficiency, enhancing the supply of follow-up care for long-term care patients so as to reduce the unnecessary use of acute care settings for these patients, improving the organisation and management of health care or introducing medical best practices systematically.

**Stock-flow adjustment.** The stock-flow adjustment has a large effect on the changes in the general government debt in Finland. This is driven by the fact that the earnings-related pension system included in the general government sector is pre-funded and is showing surpluses. The surplus was 2.5% of GDP in 2012 and is forecast by the national authorities at 2.1% for 2013 and 2014. While these surpluses are improving the general government balance, they are not reducing general government debt. These funds show up as net accumulation of financial assets in the stock-flow adjustment. Therefore, Finland's general government net financial assets position is forecast to amount to 47.1% of GDP in 2014[4]. Among the OECD countries, it is one of the highest net financial asset positions.

[4] OECD Economic Outlook no 93, Annex Table 33.

**Total stock of debt guaranteed by government**. Finland had central government guarantees amounting to 17.1% of the GDP in 2012. Only 0.5% of these were linked to the financial sector. Therefore, risks related to contingent liabilities, guarantees, financial rescue operations and debt assumptions are limited.

### 3.4. Other factors put forward by the Member State

By the letter No VM/2494/04.00.05.01/2013 received on 8 November 2013, Finland put forward the role of solidarity operations in the debt buildup, deviations in the growth forecast between Finland and the Commission and the Government Structural Policy Programme agreed in August 2013 as the factors to be considered.

The implications of solidarity operations are discussed in subsection 3.5. Subsection 3.1 addresses the recent structural reforms including the Structural Policy programme while section 2 discusses the differences between growth forecasts. The debt to GDP ratio exceeds the reference value also in the national forecast for 2014 despite the more positive growth scenario. Thus the finding on the planned breach is not based exclusively on the Commission's more negative growth forecast.

### 3.5. Other factors considered relevant by the Commission

**Financial stabilisation operations.** Among the other factors considered relevant by the Commission, particular consideration is given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances (Article 2(3), Regulation (EC) No 1467/97).

In assessing compliance with the debt criteria, financial assistance to euro area Member States with a debt increasing impact has been taken into account. For Finland, the cumulative impact of participation in the financial stabilisation operations over the period 2010-12 is 2.9% of GDP on debt (at the end of year 2012). According to the Commission 2013 Autumn Forecast, general government gross debt would be 58.1% of GDP in 2014, if debt related to financial stabilisation operations is removed from the total.

## 4. CONCLUSIONS

General government gross debt is planned to reach 60.7% of GDP in 2014, above the 60% of GDP reference value. The risk of breaching the reference value is confirmed by the Commission 2013 Autumn Forecast, which project gross debt at 61.0% of GDP. Application of the debt reduction benchmark shows that under current policies the debt ratio will not be diminishing sufficiently going forward. However, the current debt ratio has been significantly influenced by the negative cyclical position over the recent years and after correcting the debt by the cyclical factors, the debt ratio remains below the Treaty reference value. Also, the debt level has been increased by financial support to Member States for safeguarding financial stability in the euro area and by large purchases of financial assets by the social security funds.

Overall, the analysis presented in the report suggests that the debt criterion of the Treaty is fulfilled.